

**Integrated Master Program
Department of Economics
Albert-Ludwigs-University of Freiburg
Elective Courses (Second Year)**

**Lecture
Public Choice and Public Finance**

Winter Semester 2007/08

Lecturer: **Prof. Dr. Cay Folkers**
Professor of Public Economics, Ruhr-University of Bochum

Target group: IMP students (second year, MEP) and
Diploma students (Hauptstudium, anrechenbar für Pflichtfach
Wirtschaftspolitik: Ordnungspolitik, Pflichtwahlfach Ordnungs- und
Wettbewerbspolitik)

Credits: 4 Credit points

Syllabus (preliminary)

Public Choice and Public Finance

I. Introduction

The impact of public choice theory on positive and normative public finance

II. Public Goods and Fiscal Decisions

1. Orthodox theory of public goods and collective decisions
2. Majority voting on public goods provision
 - a. Simple models – one-dimensional issues
 - b. Complex models – multidimensional issues, logrolling, agenda control
3. Political power and supply of public goods
4. Pure majoritarian democracy, endogeneity of alternatives, and the supply of public goods
5. Political cooperation in a federal democracy – universalism and mutualism in public expenditure decisions
6. Constitutional rules for spending decisions

III. Taxation and Tax Reform

1. Orthodox theory of efficient and equitable taxation
 - a. The welfare cost of taxation
 - b. Optimal commodity taxation
 - c. Optimal income taxation
2. Constitutional theory of taxation
 - a. The constitutional approach to taxation
 - b. Tax institutions for Leviathan
 - c. Tax institutions for pure majoritarian democracy
3. Tax structure in representative democracies
4. Tax reform and the fiscal constitution

IV. Fiscal Federalism and European Integration

1. Orthodox theory of fiscal federalism
2. Public choice theory of federal fiscal systems
3. Fiscal federalism and the European Union
4. Public choice theory of European Integration
5. Aspects of a constitutional contract for the EU

V. Summary and Conclusions

Public choice, public sector growth, and constitutional order

Basic textbooks: Buchanan, J.M. and M.R. Flowers (1987), *The public finances*, 6th Ed., Homewood, Ill.: Richard D. Irwin

Cullis, J. and Ph. Jones (1998), *Public finance and public choice*, 2nd Ed., Oxford: Oxford University Press

Mueller, D.C. (2003), *Public choice III*, Cambridge, U.K.: Cambridge University Press

Special references

I. Introduction

- Buchanan-Flowers, chaps. 1, 9
- Cullis-Jones, chap. 1
- Buchanan, J.M. (1980), *Public choice and public finance*, in: K.W. Roskamp, Ed., *Public choice and public finance*, Paris, 11-18

II. Public Goods and Fiscal Decisions

1. Orthodox theory of public goods and collective decisions
 - Buchanan-Flowers, chaps. 3, 4
 - Cullis-Jones, chaps. 3, 4.3
 - Mueller, chaps. 2.1-2.3, 7
2. Majority voting on public goods provision
 - Buchanan-Flowers, chaps. 10, 11
 - Cullis-Jones, chaps. 4.4-4.5
 - Mueller, chaps. 5.1-5.5, 5.9, 5.12-5.13
3. Political power and the supply of public goods
 - Hillman, A.L. (2003), *Public finance and public policy*, Cambridge, U.K., Cambridge University Press, 24-50
 - Hirshleifer, J. (1998), *Stability of anarchic societies*, *The New Palgrave, Dictionary of economics and the law*, London et al, Macmillan, 495-501
 - Mc Guire, M.C., M. Olson (1996), *The economics of autocracy and majority rule*, *Journal of Economic Literature*, 72-96
 - Olson, M. (2000), *Power and prosperity*, New York, Basic Books, chaps. 1, 2
 - *Folkers, C. (2002), *Öffentliche Güter und Macht*, in: Priddat, B., H. Hegmann,

Hrsg., Finanzpolitik in der Informationsgesellschaft, Marburg, Metropolis-Verlag, 75-86

4. Pure majoritarian democracy, endogeneity of alternatives, and the supply of public goods
 - Buchanan, J.M., R.D. Congleton (1998), Politics by principle, not interest, Cambridge, U.K., Cambridge University Press, chaps. 2-5, 10
5. Political cooperation in a federal democracy
 - Mueller, chaps. 10.1-10.2
 - Stevens, J.B. (1993), The economic of collective choice, Boulder, Westview, 231-235
 - Inman, R.P., M.A. Fitts (1990), Political institutions and fiscal policy, Journal of Law, Economics, and Organization 6 special issue, 79-132 (particularly 79-99)
 - Shepsle, K.A., B.R. Weingast (1981), Political preferences for the pork barrel, American Journal of Political Science 25, 96-111
 - *Folkers, C. (1994), Politische Präferenzen und institutionelle Bedingungen der Interessenpolitik, in: Grimm, D., E. Hagenah, Staatsaufgaben, Baden-Baden, Nomos, 125-147
6. Constitutional rules for spending decisions
 - Buchanan-Flowers, chaps. 12, 15, 16
 - Buchanan, J.M. (1987), Constitutional economics, The New Palgrave, Vol. 1, London, The Macmillan Press, 585-588
 - Buchanan-Congleton (1998), chaps. 1, 10.E
 - *Folkers, C. (1996), Konstitutionelle Ökonomik und Finanzwissenschaft, in: Pies, I., M. Leschke., Hrsg., James Buchanans konstitutionelle Ökonomik, Tübingen, J.C.B. Mohr (Paul Siebeck), 111-149

III. Taxation and Tax Reform

1. Orthodox theory of efficient and equitable taxation
 - Cullis-Jones, chaps. 7.1-7.6, 15
 - Musgrave, R.A., P.G. Musgrave (1989), Public finance in theory and practice, 5th Ed., New York et al, McGraw-Hill, chap. 16
 - Rosen, H.S. (2005), Public finance, 7th Ed., Boston etc., McGraw-Hill, chaps. 13, 14
2. Constitutional theory of taxation
 - Cullis-Jones, chaps. 16.1-16.3
 - Mueller, chap. 16.6
 - Brennan, G., J.M. Buchanan (1980), The power to tax, Cambridge, U.K., Cambridge University Press, chaps. 1-4
 - Buchanan-Congleton (1998), chap. 8
 - Hayek, F.A. (1960), The constitution of liberty, London, Routledge and Kegan Paul, chap. 20
 - Olson, M. (2000), chap. 7
 - *Folkers, C. (1993), Die konstitutionelle Steuertheorie, Das Wirtschaftsstudium 22, 460-464
3. Tax structure in representative democracies
 - Cullis-Jones, chap. 16.7

- Stevens, J.B. (1993), 229-231
- Hettich, W., St.L. Winer (1997), The political economy of taxation, in: Mueller, D.C., Ed., Perspectives on public choice, Cambridge, U.K., Cambridge University Press, 481-505
- Hettich, W., St.L. Winer (1999), Democratic choice and taxation, Cambridge, U.K., Cambridge University Press, chaps. 2, 3

4. Tax reform and the fiscal constitution

- Cullis-Jones, chaps. 10.4, 16.11-16.12
- Brennan-Buchanan (1980), chaps. 8, 10
- Buchanan-Congleton, chaps. 5, 14
- Hettich, W., St.L. Winer (1999), chap. 5
- *Folkers, C. (2005), Eine Einkommensteuer für die Demokratie, in: Siegel, Th. u.a., Hrsg., Steuertheorie, Steuerpolitik und Steuerpraxis, Stuttgart, Schäffer-Poeschel, 87-108

IV. Fiscal Federalism and European Integration

1. Orthodox theory of fiscal federalism

- Buchanan-Flowers, chap. 35
- Cullis-Jones, chaps. 12.1-12.4.2
- Mueller, chaps. 10.1-10.2, 10.5

2. Public choice theory of federal fiscal systems

- Cullis-Jones, chaps. 12.7-12.9
- Mueller, chaps. 10.3-10.5
- Brennan-Buchanan (1980), chaps. 9.3-9.6

3. Fiscal Federalism and the European Union

- Cullis-Jones, chap. 12.4.3
- Carubba, C.J. (1997), Net financial transfers in the European Union: Who gets what and why?, *Journal of Politics* 59, 469-496
- *Folkers, C. (1998), Finanz- und Haushaltspolitik, in: Klemmer, P., Hrsg., *Handbuch Europäische Wirtschaftspolitik*, München, Vahlen, 559-575, 606-620

4. Public choice theory of European integration

- Hillman, A.L. (1989), The political economy of protection, Chur et al.
- Putnam, R. (1988), Diplomacy and domestic politics: The logic of two-level games, *International organization* 42, 427-460
- *Folkers, C. (2002), Politische Ökonomie und Reform des europäischen Haushalts- und Finanzsystems, in: Hegmann, H., B. Neumärker, Hrsg., *Die Europäische Union aus politökonomischer Perspektive*, Marburg, Metropolis-Verlag, 229-263

V. Summary and Conclusions

- Cullis-Jones, chap. 14
- Mueller, Chaps. 21, 28

*Additional references for German-speaking participants

Detailed contents

I. Introduction

1. Public choice, public finance, and economic methodology
2. Government as an economic unit and fiscal decisions
3. The economic logic of the state and the constitutional contract
4. The reasons for government action – market failure, public decisions, and alternative forms of government action
5. Public interest and welfare criteria – the Pareto criteria and additional measures
6. Market exchange, political exchange, and the Pareto criteria
7. First best, second best, and third best
8. Equity and social welfare functions
9. The public choice approach to equity and efficiency

II. Public Goods and Fiscal Decisions

1. Orthodox theory of public goods and collective decisions

- 1.1. Private goods, public goods, and intermediate goods
- 1.2. Public goods, prisoners' dilemmas, and chicken games
- 1.3. The optimal provision of pure public goods – the Samuelson model
- 1.4. Bargaining in small groups
- 1.5. The optimal provision of intermediate goods – the case of club goods
- 1.6. The Clarke tax and the public provision of pure public goods
- 1.7. Merit wants and merit goods
- 1.8. Exogenous norms of equity and the Arrow impossibility theorem
- 1.9. Endogenous (constitutional) norms of equity and efficiency emergent from social contract

2. Majority voting on public goods Provision

- 2.1. Standard aspects of collective decisions
- 2.2. Simple models of majority voting on public expenditures
- 2.3. The role of representatives and bureaucrats in public decisions
- 2.4. Complex majority voting models – multidimensional issues, logrolling, agenda control
- 2.5. Alternative voting rules, bargaining, and the efficiency of fiscal decisions – the optimal constitution

3. Political Power and the supply of public goods

- 3.1. The Prisoners' dilemma and the principal-agent problem in public goods provision
- 3.2. The instability of anarchy and the reasons for hegemonic takeover
- 3.3. Power and coercion: normative condition or fundamental problem of public goods provision?
- 3.4. The political economy of governmental provision of public goods – the constitutionally constrained state

4. Pure majoritarian democracy, endogeneity of alternatives, and the supply of public goods

- 4.1. Majority voting and endogeneity of alternatives
- 4.2. Majoritarian cycles and off diagonals
- 4.3. The political efficiency of generality
- 4.4. Generality and the financing of public goods

III. Taxation and Tax Reform

1. Orthodox theory of efficient and equitable taxation

a. The welfare cost of taxation

- a.1. The concept of excess burden of taxation
- a.2. The excess burden of commodity taxes and wage income taxes in partial equilibrium

a.3. The excess burden of alternative taxes on consumption and income in general equilibrium

a.4. The efficiency ranking of taxes

b. Optimal commodity taxation

b.1. Second-best rules of efficient commodity taxes – The Ramsey rule

b.2. The inverse elasticity rule and the Corlett-Hague rule

b.3. Implications of the theory of optimal commodity taxation – are uniform taxes inefficient?

c. Optimal income taxation

c.1. Efficiency and equity of taxation

c.2. Labor supply, social welfare functions, and the trade off between efficiency and equity

c.3. The optimal linear income tax

c.4. The optimal nonlinear income tax

c.5. Implications, limits, and relevance of the welfare economic approach to taxation – a critique of the theory of optimal taxation

2. Constitutional theory of taxation

a. The constitutional approach to taxation

a.1. Taxes as institutional/constitutional rules – an alternative to the welfare economic approach of taxation

a.2. The constitutional model of tax institutions

a.3. The model of governmental behavior in constitutional tax theory

b. Tax institutions for Leviathan

b.1. The Leviathan model of government

b.2. Constitutional decisions on tax bases for Leviathan

b.3. Constitutional decisions on tax rates for Leviathan

b.4. Methodological and institutional errors of the Leviathan model

b.5. The irrelevance of Leviathan rules for tax policy in democracies

c. Tax institutions for pure majoritarian democracy

- c.1. Alternative approaches of constitutional tax theory for democracy
- c.2. The model of pure majoritarian democracy
- c.3. Tax institutions for democratic states
- c.4. A comparison of tax institutions for alternative models of government
- c.5. Constitutional tax theory vs. orthodox theory
- c.6. Perspectives on tax theory and tax policy

3. Tax structure in representative democracies

- 3.1. The positive political economy of decisions on tax structures in democracies
- 3.2. Tax bases and rate structures in the probabilistic voting model
- 3.3. Extensions of the model – special provisions, relations between tax and expenditure structure, public debt finance
- 3.4. Empirical analyses on the political economy of tax structure
- 3.5. Normative implications and conclusions for tax policy

4. Tax reform and the fiscal constitution

- 4.1. The tax reform procedure – chaos instability, and the reform accelerator
- 4.2. Politics by principle, not interest
- 4.3. Tax reform as tax limits